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SMG - Q3 2018 Scotts Miracle-Gro Co Earnings Call

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OVERVIEW:

Co. reported 3Q18 net income from continuing operations of \$126m or \$2.23 per share. Expects full-year adjusted EPS to be \$3.70-3.90.



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CORPORATE PARTICIPANTS

James S. Hagedorn *The Scotts Miracle-Gro Company - Chairman & CEO*

Jim King *The Scotts Miracle-Gro Company - Chief Communications Officer and Senior VP of IR & Corporate Affairs*

Thomas Randal Coleman *The Scotts Miracle-Gro Company - Executive VP & CFO*

CONFERENCE CALL PARTICIPANTS

Christopher Michael Carey *BofA Merrill Lynch, Research Division - Research Analyst*

David Michael Stratton *Great Lakes Review - Research Analyst*

Eric Bosshard *Cleveland Research Company - Co-Founder, CEO, Co-Director of Research & Senior Research Analyst*

Jon Robert Andersen *William Blair & Company L.L.C., Research Division - Partner*

Joseph Nicholas Altobello *Raymond James & Associates, Inc., Research Division - MD and Senior Analyst*

William Bates Chappell *SunTrust Robinson Humphrey, Inc., Research Division - MD*

William Michael Reuter *BofA Merrill Lynch, Research Division - MD*

PRESENTATION

Operator

Good day, and welcome to The Scotts Miracle-Gro 2018 Third Quarter Earnings Call. Today's conference is being recorded. At this time, I'd like to turn the conference over to Jim King. Please go ahead, sir.

Jim King - *The Scotts Miracle-Gro Company - Chief Communications Officer and Senior VP of IR & Corporate Affairs*

Thank you, Celestina. Good afternoon, everyone, and welcome to our third quarter conference call. With me today in Marysville, Ohio, is our Chairman and CEO, Jim Hagedorn; and our CFO, Randy Coleman. Joining by phone from the West Coast is our President and Chief Operating Officer, Mike Lukemire, who will be available to participate during the Q&A session as well.

In a moment, Jim and Randy will share some brief prepared remarks. Afterwards, we'll open the call for your questions. (Operator Instructions) I've already scheduled time with many of you after the call this afternoon to fill in some gaps. And anybody else who wants to set up some Q&A time can call me directly at (937) 578-5622, and we'll work to set us some time as quickly as we can.

With that, let's move on to today's call. As always, we expect today to make forward-looking statements, so I want to caution you that our actual results could differ materially from what we say. Investors should familiarize themselves with the full range of risk factors that could impact our results, which are filed in our Form 10-K and filed with the Securities and Exchange Commission.

I want to remind everyone today that today's call is being recorded, and an archived version of the call will be available on our website.

With that, we'll get on and get things started. I'll turn the call over to Jim Hagedorn.

James S. Hagedorn - *The Scotts Miracle-Gro Company - Chairman & CEO*

Thanks, Jim. Hello, everybody. I want to thank those listening for your flexibility today as we rarely have an afternoon conference call. Various travel schedules in the West Coast board meeting tomorrow made this the only time that really work for our calendars. Since it's so late in the day, and I



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know many of you want to issue reports yet this evening, I'll keep my comments brief and allow Randy a bit more time to walk through the numbers and help you start to think about the key things as we enter the next phase of planning for fiscal 2019.

As it relates to our financial performance, not much has really changed since we updated our guidance in mid-June. I'll give you an update on both the U.S. consumer business and Hawthorne, not to just discuss the quarter but also, near-term trends we see in the horizon with both businesses.

I've got to start, though, with a tip of my hat for our associates. This has been an odd year to say the least. We had a historically late start to the season, followed by an off-the-chart performance in late spring, and at Hawthorne, the dramatic shift we saw in the marketplace, clearly, was not what we were expecting. But our people have maintained a focused and determined approach to their work despite all the noise around them. I've been leading this company for nearly 2 decades now and have never been more proud of our team than I am right now. A calm and steady approach with which we managed a challenging season speaks of the organizational changes we've made over time, our improved internal processes and dialogue as well as our corporate culture. I understand this is an earnings call and folks want to hear us cover the numbers, but our shareholders need to understand that the people and behaviors behind those numbers are an equally important part of the story.

So let's get into it. I want to discuss the U.S. consumer business first because the rebound we've witnessed this year has really been impressive. For years, I've talked about the strength of our category and the resilience of our brands. This here may be the best example of that I've ever seen. I want everybody to remember that consumer purchases of our products were down 15, 1-5, points midway through April and down more than 12% when we talked with you in May. It was, by far, the latest start to a season I've ever witnessed. But day after day and week after week, we kept making up ground and consumer purchases at our largest retailers have come all the way back to flat from last year's levels. Over the past 12 weeks, POS has been positive in 10 of the 12 weeks.

As we entered August, POS is either flat or up low single digits in fertilizer, grass feeds, soil, mulch, indoor gardening, indoor insect control and rodenticides. The main thing preventing us from being positive territory overall has been our weed control business. This category had the slowest start of the season due to the weather at the beginning. Entering August, POS is still down low to single digits, but we've been making up ground quickly as the season has progressed. Whether controls can catch up to the rest of the portfolio is still an unknown but I think will come close.

Market share has been another positive story for us this year. Despite the pressures we've seen at mass retail, our data shows overall market shares this year with neutral or slightly positive performance in nearly every category, about 0.5 point gain overall.

Innovation has been a big part of the story of this year, too. We continued to see strong consumer and retailer support for our new triple-action lawn care products. I talked about these products extensively on our last call, so you might want to refer back to that transcript for more details. Retailer support has been another part of the 2018 comeback story. The home centers and hardware channels collectively are up about 2% from last year. I especially want to thank them for their confidence in lawn and garden, our team and our brands. Even when the season was struggling, our retailers never flinched. They continued to run their plays to promote the season, to support innovation and to drive footsteps into the store through the cash register.

At mass retail, POS is down midteens, which is about what we expected when we started the year. That said, this channel seems to have stabilized as the season wore on. Our view going forward really hasn't changed. We are not anticipating any type of meaningful resurgence en masse, but overall, we see the potential for low single-digit POS growth over the next year, driven by home center, hardware and garden center channels.

While I'm on the subject of next year, let me share a few more high-level thoughts about how we're approaching the 2019 season. I'll start by saying that I'm really encouraged about what continues to come out the R&D pipeline. I expect the momentum we created would Roundup For Lawns last year, and with our triple-action lawn fertilizer products this year, will continue again in 2019 with the launch of Miracle-Gro Performance Organics. It's not just our most important new product launch for 2019 but one of our most important launches in years.

This product has been years in the making and is based on our own internal efforts and science. I believe that Performance Organics will prove to be the best organic fertilizer ever introduced into the consumer marketplace. For the first time ever, consumers will be able to buy an organic fertilizer with performance that is on par with traditional fertilizer. We expect the product to be especially appealing to consumers engaged in edible gardening, which, as we've said in the past, is the fastest-growing segment in the industry.



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An investor recently asked me about whether we still needed to spend as much money as we do on R&D. My response, "Of course." It's core to what we do here. And even though this is a low-growth category, innovation remains a critical component of our success. And my hats off to the R&D team and marketing team for their work on this effort. So we have real opportunities that I believe we can leverage in 2019, but we also have some challenges that are equally aggressive in addressing.

As we entered 2018 knowing that gross margins would be under pressure this year in our consumer segment, and we are willing to accept that given the strong margin performance we've seen over the past several years, however, higher freight costs, commodity inflation and tariffs are not something we can simply absorb going into 2019. We will be more aggressive-than-normal in seeking price increases. This is not an option.

Remember, we didn't take pricing in 2018. We've communicated to our retail partners that dropping 300 basis points of gross margin in a single year is not acceptable. I talked about the importance of innovation earlier. It's critical to our success and our retail success. It's always continuing to support our brands and keeping our sales force in the stores. So we really don't have any wiggle room in our pricing negotiations this year.

We're still in the midst of [line] reviews with every major retail partner for 2019, so it's too early to give you exact numbers on what we're looking for as far as pricing. But I can say, we'll be meaningfully higher than we've taken in most years.

Let me transition to Hawthorne and our integration of Sunlight supply.

While the near-term financial performance of the Hawthorne business remains much the same place as it was when we talked with you in May, a lot has changed from an operations perspective since then. The team has moved quickly and smartly on the integration of our 2 businesses and is taking a series of aggressive actions to possession Hawthorne for a strong recovery when we get through some of the current regulatory and marketplace challenges.

We told you when we announced this transaction that we expected at least \$35 million of synergies. We are well on our way to accomplishing that goal. On the day we closed the deal, we announced a plan for associates called Project Catalyst, which is primarily focused on driving those synergies. Within a week of launching Project Catalyst, we had already begun combining our 2 workforces, which were redundant in several key areas.

That led to the difficult decision to eliminate roughly 175 positions thus far, and we have been recording restructuring charges related to those changes. At this point, we're already more than halfway through our synergy goal with the majority of the balance coming through facility consolidation.

Our plans call for us to move all of our durable manufacturing to Vancouver, Washington, where Sunlight is based, in a recently opened brand-new best-in-class facility.

We will move all of our liquid manufacturing operations to Santa Rosa, the site of our General Hydroponics facility. And most of our West Coast growing media operations will be based at our [Oliver], California facility. When all is said and done, sometime later in 2019, we will be migrating from our original footprint of 11 facilities to just 5. For all intents and purposes, the hydroponic growing supply business is now being managed from the West Coast. Chris Hagedorn has located there and is working closely alongside his Chief Operator, Doug Hargreaves. Leaders from both organizations, the best of the best in sales, marketing, supply chain, business development, finance, legal and human resources are now based in Vancouver or in the midst of moving there or in a minimum spending the majority of their time there. I'm extremely pleased with how well and how quickly this team has coalesced.

In addition to the integration, the transformation of the Hawthorne business model is happening at a rapid pace. We are changing the hydroponics goods marketplace and everyone in this industry can see it in the following ways: we're bringing innovation to the market with new lighting products in Gavita and new hardware from Botanicare; we're creating promotional programs for the entire portfolio that are gaining traction in the retail channel unaccustomed to the kind of aggressive and innovative selling we've introduced; we're investing more heavily in a level of technical product support that no one in this industry has seen in the past;



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we're moving forward with our Canadian research facility to create truly unique Canada-specific R&D platform; we're leading the dialogue with political leaders at both the federal and state level to open new markets and bring a rational approach to legislation in this industry; we're leveraging the competitive strength of our entire business to help our retail customers, consumer and vendor partners be more successful; and we're building stronger product awareness with new players in the emerging professional space on both coasts.

What's all that mean? It means we're distancing ourselves from our competitors and clearly establishing Hawthorne as the market leader. None of this is designed for short-term gain. The societal and legislature trends are on our side. Clearly, the market has been disruptive this year. And even when it recovers, we expect things to remain volatile at times. But the long-term opportunities in this space remain significant for those willing and capable of taking a long-term approach. We are, and I remain convinced -- and I remain a convinced shareholder with a long-term investment horizon and everyone will benefit from that.

So while I'm bullish about the progress we're making, it's been a challenging year for Hawthorne, primarily for reasons outside of our control. While we need to reset the base for future growth, we still have a great deal of confidence in the opportunities on the horizon. As we look into the calendar for year 2019, we're optimistic that the regulatory environment will improve in California, that several important markets in the state will reopen and that the existing counties issuing cultivator licenses will continue to accelerate the pace of their approvals. Additionally, the state itself is reporting that it remains on pace to begin issuing permanent licenses sometime in August.

Another important thing to focus on is what's happening with consumers. Consumption of authorized cannabis products continues to increase in the mid- to high single digits and more states continue to make progress in further expanding the marketplace. As we look into 2019, we believe we'll start to see growth again and are likely to start the year with an assumption of mid-single-digit increases. This assumption is based on the fact that we feel like we've hit the bottom. The rate of sales decline improved in Q3 over Q2, and we see even more positive signs in July. This point of view regarding 2019 is realtime for us. It could change again by the time we do our year-end call in November given the volatility of the market. So while this is far from a commitment, it at least helps you all better understand our current view.

Before I turn the call over to Randy, I want to emphasize 2 more points. First, we've got 2 full months left in our current fiscal year, and we're going to work as hard as we can right through the finish line. We feel good about the revised guidance we provided and believes it strikes the right balance in terms of getting the most out of 2018 without being so aggressive that it hinders our ability to recover next year.

Second, cash flow remains my primary focus in terms of financial metrics. I'm not being dismissive of earnings, it's an important metric but at the end of the day, it's cash flow and not EPS, in our opinion, that drives value. Our supply chain team has been doing a great job throughout the season on managing inventory levels, and I would expect our cash flow productivity number to exceed 100% again this year. We've used our cash over the last several years to supplement shareholder returns and we've used our balance sheet to position our portfolio for the future. But as Randy will explain in more detail, our approach is now shifting as we use our cash that delever from the Sunlight transaction as quickly as possible so that we can return to our stated goal to return more cash to shareholders. In fact, that's the #1 financial goal for everyone here as we look into 2019.

In terms of other priorities for 2019, don't expect us to deviate. We're going to keep doing what we promised. We're focused on integrating the Sunlight deal, we are committing to get back the positive growth for Hawthorne, we're focused on bringing new products to the market in our consumer segment and we're working to keep our core consumer engaged in lawn and garden.

The second half of fiscal 2018 is giving us some positive momentum as we look ahead, and that gives me confidence that we'll soon get back on track delivering the kinds of returns our shareholders expect and deserve. With that, let me turn things over to Randy.

Thomas Randal Coleman - *The Scotts Miracle-Gro Company - Executive VP & CFO*

Thank you, Jim, and hello, everybody. Given the fact that our outlook remains in line with the updated guidance we provided in mid-June, I'll be as brief as possible. I will touch on some of the key areas of the P&L and discuss our performance as it relates to cash flow productivity. I'll also talk about some of the big headlines we're looking at as we enter the next phases of our planning for 2019. I do want to be clear that we're not providing 2019 guidance today. I'd ask that you keep that in mind during the Q&A. Jim already touched on a few areas of focus for next year, and I want to share some of my early thoughts as well.



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Before I jump into the numbers, I want to explain some of the nuances of how we're treating the acquisition of Sunlight Supply. As you know, this is not a normal acquisition, as we're not simply adding their sales numbers to ours. For example, about \$80 million of Hawthorne annual sales went through Sunlight Supply as our largest distributor before the acquisition. Therefore, we'll be double counting the numbers if we simply added the 2 business together. So as it relates to the impact of acquired Sunlight sales on our sales growth and gross margin metrics, this is how we're looking at the numbers. Sales of Sunlight's own brands as well as the distribution of third-party brands will be treated as acquired sales until such time that we anniversary the deal. However, acquired sales of Hawthorne products by Sunlight will only reflect the incremental distribution margin that Sunlight earned on the sale of our products to the end customer. In other words, if Sunlight had \$100 of Hawthorne sales to the end customer in a quarter that we sold at a 20% margin, then we'll view \$20 as an acquired sale when calculating our financial metrics. We do not intend to provide a bridge to every category, every brand, but we'll simply employ that example for the aggregate number. With that, let's move on.

Sales in the third quarter were up 2% overall with the U.S. Consumer segment up 1% and Hawthorne up 2%, including the impact of acquisition. Hawthorne's sales were down 33% in the quarter, excluding acquisitions. This is a slight improvement from the Q2 organic sales decline. Sales on a year-to-date basis were down 2% companywide, with the U.S. and consumer -- U.S. Consumer and Hawthorne segments down 2% and 1%, respectively. The year-to-date number in the U.S. Consumer segment is in line with where we expect to finish the year, and we expect Hawthorne to be up about 25%, including Sunlight.

I want to add a bit of personal commentary here about the U.S. Consumer segment. Jim talked about the strong recovery we've seen from a POS perspective in the core business. I just want to reiterate that I've never seen a season like this during my 19 years here. But for as long as I've been CFO, I've been telling investors that weather tends to even itself out over the course of the season. In extreme seasons, the weather impact is usually not more than 1 point or 2. And that's exactly what we've seen this year. We're likely to wind up about 2 points below our original guidance despite the slow start to the season in our memories. The team here did an outstanding job staying focused, not [fretting] about the slow start and sticking to the game plan. Given the circumstances, I'm more than pleased with the results we've seen on the top line this season.

I'm not quite as pleased with the adjusted gross margin rate, which was down 330 basis points in the quarter. The same things I outlined in the previous quarter still apply. We saw about 100 basis points of pressure from higher distribution, a similar decline is related to product mix and the acquisitions. And in Q3, as we expected, the reversal of trade program expense was the most pronounced. And this was the other primary driver of the decline.

Our adjusted full year guidance calls for a 250 to 300 basis point decline in the gross margin rate. At this point, we're likely to be in the higher end of that range. SG&A, however, continues to be a positive story, as we reported a 6% decline in the quarter and 4% decline year-to-date. Variable pay was both a benefit and a headwind in the quarter. Because our earnings performance will be well below expectations this year, we reduced the accrual for annual bonuses compared with last year. At the same time, because of our strong cash flow performance over the last 2 years and our expectations for the future, we increased our accrual for our long-term incentive plan. You will recall that our executive equity pay plan outlined in the proxy is 2/3 based on cumulative cash flow over a 5-year period. We head out of the gate strongly last year, continue to make good progress on working capital improvements this year and continue to expect progress for the remainder of the planning period. This decision means the accrual for long-term incentives is unlikely to be an impactful headwind next year. However, we expect that the reduction in annual bonuses will reverse itself in 2019, and is therefore, a likely headwind, a point that I'll elaborate on later in my remarks.

Interest expense increased roughly \$1.5 million to \$23.2 million and is in line with what we expected. The increase is largely due to higher borrowing levels associated with the acquisition we made in Hawthorne. Since the closing of the Sunlight deal, we made some changes to our current facility. I'll elaborate further on what we did and why in a few moments.

Another item below the operating line worth pointing out is equity income. The number in the quarter was \$1 million compared to the GAAP number of \$7 million and non-GAAP amount of \$12 million last year. It's important to remember that we anticipated this level of change due to the fact that we're not recording equity income this year from our 30% interest in TruGreen. This had a positive impact in our earnings in Q2 because it was a loss quarter for TruGreen. It was obviously negative in Q3 and will be slightly negative in Q4 as well.

It's worth noting that the TruGreen business is performing in line with expectations. And I would expect the business to deliver more than \$180 million of EBITDA on a calendar year basis. Let me also point out that our effective tax rate was about 24.5% in the quarter, reflecting our increasing



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confidence and assumptions around the new federal tax code and the impact on our results. We most recently guided to a 25% to 26% tax rate for the full year, and we now expect to be slightly better.

Back to our results. Net income from continuing operations in the quarter was \$126 million or \$2.23 per share compared with \$145 million or \$2.41 per share a year earlier. During the period, we incurred restructuring charges of \$12.9 million. We also recorded a \$17.5 million noncash impairment charge related to previously acquired customer relationship and tangible assets associated with Sunlight due to the deal. We also reduced by \$7.3 million the value of the deferred tax liabilities associated with that writeoff.

The other item I wanted to point out is that we had established a \$65 million accrual related to recent development in a litigation matter that we disclosed for several years in our SEC filings. This is related to an unresolved class action lawsuit filed in 2012 in connection to the sale of wild bird food products that were subject to a voluntary recall in 2008. While we recorded an accrual, the company continues to vigorously dispute the allegations in this case. Since we divested this business several years ago, the accruals and discontinued operations, therefore, does not affect EPS numbers, though, we historically included a narrative of the press release, and a discussion on these calls. However, this item is included in the press release financials, and I wanted to make sure I pointed it out.

Excluding the restructuring cost, noncash impairment and other onetime items, our non-GAAP adjusted income, which is the basis of our guidance, was \$150 million or \$2.67 per share compared with \$148 million or \$2.47 per share a year ago.

Next, I want to remind everyone of what items were not excluded from our adjusted earnings as a result on the Sunlight transaction. We did not exclude deal cost and purchase accounting adjustments related to the write-off of inventory from our adjusted results. I understand that these could be viewed as nonrecurring charges and that many companies often do exclude them in a deal like this. I also realize that I just outlined a list of other onetime items that we did exclude. We also did not exclude the increased interest expense or amortization associated with the deal as these items truly are recurring in nature. In fact, both will increase next year as we have 8 additional months of each item impacting our full year results pick. Our decision on what to include and what to excluded from adjusted earnings is consistent with our practices dating back many years.

The combination of all these items, purchase accounting adjustments, related inventory write-ups, deal costs, increased interest and increased amortization had roughly \$0.11 per share impact on our adjusted EPS during the quarter. As Jim said earlier, while the integration is doing well and our key vendor partners and retailers have been receptive to the Hawthorne-Sunlight combination, we still expect some dissnergies on the top line. We are currently trending at the midpoint of our estimate for \$0.30 to \$0.40 of dilution from this transaction in fiscal 2018.

Pulling all this together, we remain comfortable with the revised full year guidance for adjusted EPS that we provided in June, which was a range of \$3.70 to \$3.90 per share. Before I talk about other trends that will impact our results for next year, I want to briefly touch on the balance sheet and then move on to discuss cash flow. While inventory is up \$87 million on a year-over-year basis, more than 100% of that increase is due to acquisition. When you look just at the U.S. Consumer segment, inventory is down about \$25 million as we continue to put a heavy focus on working capital improvement and cash flow productivity. While our free cash flow number will obviously fall short of 2017 due to lower net income, we still expect a free cash flow productivity number above 100% for the second year in a row. And as we look ahead, that remains the single most important metric we're focused on. We believe we still have room for improvement and managing working capital and in improving our free cash flow number over the next few years. For now, we remain committed to using the majority of that cash, except for paying quarterly dividends, to repay debt until we get our leverage ratio to 3.5x. Our Q3 leverage ratio, including the impact of the sunlight acquisition, is at 4x. That is higher than I prefer but we believe it was worth going a little higher than our internal target to acquire this business.

Note the current leverage ratio used for our credit facility is calculated on a rolling 4-quarter average and on a pro forma basis, using trailing 12 months of EBITDA and \$35 million of synergies from the Sunlight acquisition. The calculation also excludes the \$65 million accrual for the bird food litigation matter. I also want to share in recent weeks, we have modified our credit facility, giving us access to \$2.3 billion in credit. As part of that facility, our debt covenants now allow for a maximum leverage ratio up to 5.25x although it returns to the previous level of 4.5x over the next 2 years. To be clear, we have no intention of taking leverage up from here, but I prefer to have at least a full term of cushion and the new facility gives us that piece of mind.



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Our focus on delevering means we'll do only a modest amount of share repurchase activity over the next several quarters. While I'd like to stay in the market to repurchase enough shares to offset dilution, we'll be making that decision on a quarter-to-quarter basis. With that, I'm going to spend the last few minutes to outline some of the main themes as we enter the next stages of planning for 2019. We'll be more specific in November as it relates to guidance but here are some things to keep in mind.

Since we modified our Roundup agency agreement in 2015, we've been telling you that we would see a reduction in a Roundup ratings of \$20 million a year beginning in 2019. That reality is now upon us. You might recall that we actually earned \$20 million more a year from Monsanto in 2016, '17 and '18. Those dollars helped us fund the R&D and marketing efforts to create new Roundup-branded products like Roundup For Lawns. The profit we expect to make from those brand extensions this year is in line with the \$20 million reduction we'll see next year. Still, it's a headwind that you should be thinking about.

As we've said earlier, we see no near-term relief in either distribution or commodities for next year and tariffs will be a headwind as well. So we expect at least \$20 million of pressure on the cost of good line in 2019. We've been marketing costs already for 2019, and see no reason to believe the negative pressure here will bake anytime soon.

I mentioned earlier that SG&A has been a good story for us this year, but some of those benefits will turn into headwinds next year. Specifically, wage inflation will be the biggest driver of roughly \$20 million expected increase in SG&A next year. We, like most other companies, continue to see pressure on wages and given the frothy economy, now we're going to have to increase salaries to keep our people and to remain competitive. So the Roundup COGS and waste pressures that we expect to see all add up to roughly \$60 million. We expect price and volume increases next year and the U.S. Consumer segment will largely offset those pressures.

However, we're also planning for the reversal of variable compensation expense next year. That's likely to be another \$15 million to \$20 million. While a strong rebound from this year's difficult lawn and garden season may be enough to offset these costs, the reversal of variable pay also may not be a headwind that we can overcome.

While I'm pointing out some of the pressures for next year, I also remain enthusiastic about the underlying strength of the U.S. Consumer segment. As Jim said earlier, POS is up about 2% this year outside of mass retail and we've seen a positive traction with our new innovation. The recovery we've seen in the second half of this year further cements my view that the vast majority of our consumers consider lawn and garden products as a consumer staple and that gives me confidence in our long-term outlook.

Let me also share some thoughts about Hawthorne. As Jim said, we're on track to achieve our synergy targets for the Sunlight acquisition and the Hawthorne team is moving aggressively on its integration efforts. I continue to expect the benefits that Sunlight acquisition to result in significant year-over-year improvement and adjusted EPS. However, as we integrate, it's becoming increasingly difficult to separately measure Sunlight results from the historic Hawthorne business. So we'll likely speak only to combine Hawthorne results once we provide guidance for 2019.

That said, the volume pressure we see in the business this year continues to be greater than we had anticipated. Therefore, we're going to be growing the business off of a lower base than we anticipated when we announced the deal. We're still in the midst of finalizing plans for next year, so it's too early to provide more details at this point. I do want to point out, however, that the goal we announced in April of segment income of \$120 million in 2020 is unlikely to be achieved without greater volume increases than we're currently planning. I will provide some updated long-term thoughts in the future call.

As we told you during our last call, we gave ourselves a fair amount of flexibility when we value the Sunlight deal because of the current volatility in the hydroponics market place. Nothing about our competitive position has exchanged, and the benefit of this transaction remain overwhelming. I share Jim's view about the pace in which we're integrating these businesses. I also remain optimistic about our ability to serve both the consumer and the professional segments of the industry.

So when I net it all out, I continue to be positive about our strategy and our execution. I remain optimistic that we'll be back on a positive trajectory in 2019, and we have continued working to improve shareholder value. And with that, let me turn things over to the operator and open the call to your questions.



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QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And we'll take our first question from Bill Chappell from SunTrust.

William Bates Chappell - SunTrust Robinson Humphrey, Inc., Research Division - MD

Randy, since you gave so many pieces about guidance even though you said don't talk about next year. Just trying to understand on account on pricing, I mean, am I right in saying every 1% of pricing offsets about \$20 million of costs? And historically, you've done more than 2% to 30% of pricing before. So I'm just trying to understand, are you saying that pricing can offset everything except for SG&A and then we should assume that the profitability in North America is down for the variable comp coming back?

Thomas Randal Coleman - The Scotts Miracle-Gro Company - Executive VP & CFO

Like I said, Bill, we're not providing guidance. But like you said, we are dropping a lot of bread crumbs because we're getting a lot of questions and we want to be as transparent as possible. So historically, we've taken pricing 8 out of the last 10 years. Historically, that amount is 0.5 point to 1 point. We've had pricing in years as high as 10% if you go back by the decade. So we'll be taking pricing somewhere between 1% and 10%, Bill. But more to come on that. We're just engaging on line reviews now. But clearly, we need to take pricing -- we have a lot of commodity headwinds. The tariffs, we're continuing to evaluate to see what that's going to mean for us. The freight issues, we don't expect to abate. So pricing is something we definitely need to do, but being more specific in that right now, I don't think it's appropriate to do that at this point.

William Bates Chappell - SunTrust Robinson Humphrey, Inc., Research Division - MD

Okay. I'll work with that 1% to 10% range. With regards to Hawthorne and maybe Sunlight, can you just give us maybe a few more breadcrumbs of what gives you confidence that the business has bottomed out other than the rate of decline has lessened from last quarter to this quarter? I mean, in terms of is Sunlight -- are Sunlight trends versus Hawthorne, I mean, are they more stable? Or are there number of licenses coming out of California ramping up by months? Anything you can give us just to help us get more comfortable.

James S. Hagedorn - The Scotts Miracle-Gro Company - Chairman & CEO

Well, we know the answer to the latter part is yes and I think Jim is working the sort of government side and so he's got the data, and he can share that with you guys later on sort of the licenses that are out, the counties that are accepting licenses and approving. So I think we've got actually a lot of data on that. I think, number one, we're starting to see activity and sales. A lot of -- I mean, I would say, we're doing promotional work right now. We're program selling like we would in our sort of consumers side and I think making progress and, I'd say, taking share. One of the things we also see is a major part of what was happening in California was over production of product and what we're hearing, and I mean directly, is that a lot of dispensaries are running short of product right now. And so there is pressure to grow, and we're seeing that on the sales side. So I think that it's -- we're actually seeing evidence that the business is beginning to pick up and so that, I think, is -- so I think the license front is a happy thing. The -- it was a question of how long is he going to take for this overproduction, which didn't just infect California, it infected, really, the whole West Coast. So Oregon and Washington state, also, I think, were dealing with sort of this little bit the gold rushes. California went consumer adult use and the regulations. So I think they're still a disappointment that the legalization efforts, I think, have been challenging. And I don't think -- you don't have to believe us on that. I've seen so much writing in so many papers about how badly it screwed up the marketplace. That's true, but there's was also an overproduction just as people sort of said we should overproduce to be ready for this crazy demand, to which I'm not sure completely materialized. And remember, part of the issue was dispensary license were affected just the same way. And so I think we're seeing actually evidence that's -- I'm not sure that anybody around this table would say, we should say we're free and clear. But I do think that we're beginning to see some light at the end of the tunnel that makes us feel comfortable that those market dynamics, plus, I think, the program selling



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and the work that the sales force is doing, plus the innovations and sort of the market power of the combination of call it the new Hawthorne is good.

Operator

And we'll take our next question from William Reuter from Bank of America.

William Michael Reuter - BofA Merrill Lynch, Research Division - MD

My question is with regard to you said you're going to slow down share repurchases in the near term. I guess, how are you thinking about a target for leverage in the context of that over the next couple of years? And I know you've talked a lot about returning cash to shareholders and that being the driving force for the next couple of years. Would you say that you're at the point where there will not be any more incremental Hawthorne acquisitions?

James S. Hagedorn - The Scotts Miracle-Gro Company - Chairman & CEO

On that one, yes. I think from Randy and my point of view, if you look at what the 2 of us do and sort of, I think, more or less get paid for, which is sort of, to some extent, own the strategy and also allocation of capital for the businesses, we take that job pretty seriously. And we just did the biggest acquisition, I think, since I've been here. So in that careful-what-you-wish-for thing, they got -- the operators got what they wanted, and we're super comfortable with that. But Randy knows what his main job is sort of when it comes to the main operations of the business, which is...

Thomas Randal Coleman - The Scotts Miracle-Gro Company - Executive VP & CFO

Don't run out of money.

James S. Hagedorn - The Scotts Miracle-Gro Company - Chairman & CEO

And so I think the new debt facility is good. I think the pricing is good, it gives us more capacity. We've got room on sort of leverage, covenants, which is, again, not because we wanted but just in case this stuff happens, we're not -- I'm not looking at Randy and saying that, "Yo, I said don't run out of money." So I think we feel very comfortable where we are today. We intend to, as quickly as possible, get back to the sort of next phase of our strategy. And I -- so this will be a little bit of a longer answer maybe than you wanted. We looked at this business, I don't know, call it, 3 or 4 years ago, and said, is this the business we want? I mean, and we said, we would reconfigure this business. We convinced our board of that, we convinced ourselves of that, we convinced our shareholders of that. And that was divest Europe, effectively divest our service business, reinvest that money in live goods and reinvest that in hydroponics. And we've gone through talking about that to executing that. We are now in the sort of head down period of digesting it in a, I'm going to say, a challenging commercial environment, particularly on the hydro side. And so I think that's probably delayed our getting back to -- I mean, I think Randy was clear on what kind of leverage are we targeting on a go-forward basis, and I think what we said is 3.5, roughly. And so book -- acquisition book is closed for everyone, okay? It's paydown debt time, digest time, execute, get our synergies, integrate these businesses, attack the basis and be what we've said we wanted to be, which is the preeminent supplier in this professional industry. And we are doing that. So I'm going to say, in the short-term, and I don't know exactly what that is because I think the performance of Hawthorne has set us back a little bit on when do you think that we'll be back in the market sort of either buying shares back or with special dividends, call it, but our shareholder-friendly world. I think we're probably delayed 1 year or so, maybe 2 from where we are. I think this is just the internal numbers we're talking about. But the book is closed. It's delever. We get back to 3.5, it's the next phase of the business, which is to, I mean, effectively my view right now is staying just reduce our -- shareholder friendly, return value to our shareholders and have a bias on share repurchase and reducing share count. And that remains our goal and we are -- everything is about how fast we can get back to that leverage ratio and get back to being shareholder-friendly. And so I think this was our plan all along. We're executing the plan. We are nearly in the sort of third phase of it, which is execution moving to shareholder friendly.



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Operator

We'll take over next question from Joe Altobello from Raymond James.

Joseph Nicholas Altobello - Raymond James & Associates, Inc., Research Division - MD and Senior Analyst

Just wanted to follow up on Hawthorne with a few questions. I guess, first, you mentioned earlier here that you were encouraged by what you saw in July. And maybe could you elaborate on that? Was there a meaningful improvement from the 37% decline that you saw in Q3? Or is things that are happening on the ground that haven't translated into sales yet?

Thomas Randal Coleman - The Scotts Miracle-Gro Company - Executive VP & CFO

So Joe, we are seeing some improvement in July and things aren't turning back to positive numbers at this point, but we have seen, in some of the signature brands, specifically, some improvement. And we are being very competitive in the marketplace right now. And we're seeing good results from that post-acquisition. So again, it's too early to say we've turned the corner, but we are seeing some positive signs, and we think it's just a matter of time.

James S. Hagedorn - The Scotts Miracle-Gro Company - Chairman & CEO

And I don't want to leave the last part of that -- the second sort of part of that, which is the work that's occurring in Vancouver and giving credit to Chris and his team out there. We have -- it's not that we didn't integrate all these businesses, but we ran Botanicare out of Arizona -- we had all these businesses over all over the place. The reason that we're calling this Project Catalyst, it was the catalyst to actually squish everything together. And so that is a bunch of cultures, a bunch of different companies, a bunch of different locations, everybody effectively is moving into Vancouver. And you've got to take those different cultures and create 1 team out of that and that's happened really well. And I think, in some part, we had the saying in the Air Force, change is the result of a significant emotional event, I think the significant emotional event in this commercial space has really caused them to accelerate their efforts to integrate sort of into 1 business and I think they deserve a boatload of credit for that. At the same time -- going from, I think it was 11 to 5 sites, that's major effort and hard work and hard on the people because there were a lot of people, particularly on the Hawthorne side, as we move more of our work into Vancouver, that were impacted from a job point of view. And I think that shows -- look, it was all planned and as part of our integration planning, but it's still hard to do when you're the leadership group and people look at you and you have these waves of sort of redundancies, as they'd call them in the U.K. In addition, at the same time, they've got to define their business model going forward. And what's clear to me, and I know this is the case in Vancouver, is the market is changing. What's happening in California, which I think is going to be happening sort of across the country, and we are prepared for this, is a much more professional large-scale growing operations as a result of these legalization efforts and permitting process. I think it is actually -- it favors larger grows. And there's money queued up to invest in that space. And so this is not just the disruption of the market going through the process of much stiffer regulation in California, a good market by the way. But it's really changing from a little bit more of a hobbyist market or small grower to mid or large grower operations and this configuration, which is kind of, call it, hydro professional or whatever you want to call it, but it's a pro-business. It's starting to look and feel a little bit more like the kind of Canadian LPs. And this is a business we understand and we're adapting to. And we have a lot of experience both in ProHort and in Pro Turf to have a model that I think was as good as it was in that space. So while all this is occurring, this disruption, they've got to integrate the business, they've got to chase their synergy numbers and get them because we have no room. Randy has no sense of humor for disappointment there. And they've got to drive the business of the future while the business is changing. As a result, I really think of these legalization things. It's -- I could go through a longer speech about I don't really like it just because I think the culture of the sort of West Coast California cannabis business is becoming more businesslike. But maybe we're just a part of that to. But that just means we've got to adapt our business. And they're doing all that at the same time and I think successfully. And I come away -- even if they don't see it. Because people have asked me like, "Where are they at?" And I said, "Dark days, dude." They've gotten a lot -- they're head down hard. These are long days and there's fear. And I think Randy and I were talking earlier today, which is, the benefit of a little bit grayer hair, and I'm really talking to people in Vancouver right now, is this ain't our first rodeo, man. We've done this. What I know about this, this is a real business, it's billions of dollars, and we're going to win. So I know the outcome of this game, okay? Doing it is harder, and I give them all the credit out there, but Randy and I are a little less frantic maybe than you all are because I know



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where we're going, I know they're on track. And I know the market dynamics here as far as consumption of the product is good for us, and we're developing a business that will be absolutely essential to anybody who's professionally growing this product.

Joseph Nicholas Altobello - *Raymond James & Associates, Inc., Research Division - MD and Senior Analyst*

Just 1 quick follow-up, if I could. I think, Randy, you mentioned earlier expecting mid-single-digit growth for Hawthorne next year. What's the base that you're using for that number? Because I know there was a fair amount of dissynergies with Sunlight and obviously the intercompany eliminations as well. So if you could help us out in terms of what the pro forma revenue base is today and what you're expecting for next year.

Thomas Randal Coleman - *The Scotts Miracle-Gro Company - Executive VP & CFO*

Sure. So absolute number for this year, I think the most recent guided -- guidance we provided was somewhere between \$550 million and \$600 million. So I think that's still an appropriate range. There's still a lot to be pulled in over the next couple of months, but somewhere in that range is probably a good starting point.

Operator

And we'll take our next question from Chris Carey from Bank of America Merrill Lynch.

Christopher Michael Carey - *BofA Merrill Lynch, Research Division - Research Analyst*

So just a follow-up on this line of questioning. I appreciate that the hydroponic industry remains challenged right now, which makes it difficult to forecast growth or to reiterate your prior accretion expectations for Sunlight for fiscal '19. But I guess, just to beyond the disruption that you're seeing in the market from overproduction or new regulations, how do you feel about the positioning of this business over the longer-term? And specifically, how do you see the lighting and branded nutrients businesses positioned as the industry maybe shifts away from the smaller growers and potentially contemplates other growing methods like outdoors or greenhouse?

James S. Hagedorn - *The Scotts Miracle-Gro Company - Chairman & CEO*

I don't know where to start. I've got a good answer and I feel strongly about it. I personally was a supporter of the new governor of New Jersey. I've met with him. I feel very confident that they're going to legislatively deal with cannabis in the state of New Jersey, and I think, based on the trends, you're going to see the same thing in Connecticut and New York, and I think pretty rapidly personally. I can't predict how -- I'm sort of disappointed it hasn't happened in New Jersey already, but I think during their '19 session, I think there's a good chance that gets dealt with, and I think New York will -- listen, if you hear the -- I don't know where you're based, but I think if you listen to the governor and you listen to the mayor, there's a lot of pressure to sort of harmonize, I think, with where New Jersey is going, and I think Connecticut will follow. And if you look at those to the 3 states alone, those are not going to be outdoor states, okay? The weather doesn't support that. So I think they're likely to be indoor. I'm not sure I care if they're greenhouse because they still need lighting. Nobody is going to be 100% without lighting. And I think we've got a lot of innovation coming down the track and particularly with LEDs, which will supplement sort of greenhouse production. So if you look at those 3 states, those states are bigger than California. If you combine it. So this would be like another -- California, I think, up till now, I think, we would have said represents about 52% of Hawthorne's business. Just that New York tri-state area, it's as big as California. And that's not online at all. So -- and I feel fairly confident and I would, maybe not on this call, but enjoy anybody arguing that that's not going to happen. So I feel really confident there. If you look at growth in purely medical states, I think we have been super surprised by the state of Florida. The state of Florida is just a medical state with actually a pretty tight criteria, but it's an important and fast-growing customer for us. So -- and I think if you just look -- there may be some states that are conservative and don't want to press forward. I don't think that you're probably going to see the federal government in the short-term deschedule. And I'm not sure that we actually really care that much about it. I think what we're looking for is sort of keeping DOJ from enforcing sort of beyond what was in the Cole memo. And I think you've seen -- I think we've seen good progress in both the House and in the Senate in annual spending bills, which we hadn't seen before. We were making progress in continuing resolutions with Rohrabacher, which was a language



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that prohibits DOJ from using appropriated funds against medical states. That language has been expanded and put into annual appropriations bills, really, led out of the Senate but supported in the House. And there's a lot of people we should thank for that but including our own government people. So I think you're not likely to see the feds interfering in the business. And I think, over time, you could see -- which would be very welcome. Because in the Senate side there's a lot of work with Gardner from Colorado and other senators to sort of fix banking, fix tax and one-time deal with this issue, where something is legal in a state, it is not going to be a federal crime to do something that's legal in a state. And so there's discussions. I think there's a lot of support. I think the Democratic minority in the Senate, the leadership is very much in support of that and the leadership on the Republican side has not been particularly challenging. The House is making a lot of progress there. So I don't think I you're going to see sort of a lot of federal interference. And I think that consumer attitudes, just nationally and in the states individually, are positive. So our view is that this is a real multibillion-dollar industry. And you sort of have to believe or not believe. And I will -- Mike Porter was on our board. And when I first brought this up like 5 years ago, Dr. Porter From Harvard, who has been my strategy consigliere for many years, decades, was kind of against it at first, and as was our board. That's not the case now, and I was talking to Mike, who is not on the board any longer, and said, "Why have you changed, Mike?" And he said, "Jim, it's a real market. It's obvious this is not being turned back, meaning it's going to ultimately be federally legal, and you have first mover advantage." And I think that ultimately drives us here and gets us through the fact that it's a little bit of an ugly world out there. Largely as these states legalize -- I've been criticized and on like industry message boards saying, "Aw, Hagedorn blaming everything on a botched legalization." Dude, California was a wonderful market and it was a lightly regulated medical market. Going recreational/adult use, we all thought was going to be awesome. But if you ever want to see how politicians can screw something up, dude, I could take you through county counts, I could take you through sort of volume by county, we have a lot of data today to say this is no joke, and it's well written about as far as how poorly this has gone. And it's a state that represents 52% of our business. So what do I think? I think California is going to get back online and we already seeing that. And I think you're going to see other states come online, and I think you're going to see a lot of that in the east. So I think a lot of this action is going to be east of the Mississippi, and those are indoor markets, okay? And therefore, our business is well adapted to that. And while there is going to be some outdoor markets in more temperate climates, we're going to have products for those guys, too. So we do not intend to be left behind in any of the markets. (inaudible)

Christopher Michael Carey - *BofA Merrill Lynch, Research Division - Research Analyst*

Just 1 follow-up, if I could. You guys mentioned in June that there were some big-money players entering the hydroponics space. I wonder if you could elaborate on that. Where are you seeing increased competition? Is it on the durables side? Is it on the consumables side?

James S. Hagedorn - *The Scotts Miracle-Gro Company - Chairman & CEO*

No. I think what we were talking about was that in hydroponics, particularly in like leafy greens and indoor vegetables that you're seeing a lot of smart money going into indoor, more locally-grown edible products. There is definitely a lot of money going into the cannabis side, for sure. And all you've got to do is look at the Canadian public market, which is a little bit beyond belief. But I would say that there is smart money on both sides of this, both on the cannabis side -- I think there's no shortage of people willing to invest on the growth side. I think our business is better, by the way. But I think in Canada, you're seeing very smart, intelligent money going into legal public equities that are underlying that business through Canada and the rest of the world, where that's how they view their market. So I think, on the edible side, there's just a lot of really smart guys and famous names that Jim can talk to you about. But we view that as an important part of our business as well. If we're a high-performance indoor nutrient, lighting, all the stuff that we do, I don't think we should just be focusing on cannabis. I think indoor, locally-grown produce is an important part. And one of the things that does for us -- and again this is like probably more than you care about, but LEDs for cannabis are just not perfect yet. We're making a ton of progress in getting them better, and we have a lot of important partnerships to help with that. But the leafy green business is actually a business that can do really well with LEDs, and I think it's important that we have markets that help us get our feet in and innovate in LEDs because, ultimately, if you look at this single largest cost a grower has today, it's electric power. And never mind the environmental side of that, just from a cost point of view, if you could just get 20% out of the cost of energy in these indoor greenhouses, that would be huge. So LED is clearly an important like technology going forward. It just needs a little more work before it's capable of taking the place of these sort of high-energy-consuming metal lights.



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Thomas Randal Coleman - *The Scotts Miracle-Gro Company - Executive VP & CFO*

And while we're not necessarily focused on food propagation and flowers in the U.S., that's almost exclusively what our business is in Europe, and that's about half the volume of our lights business, just as an FYI.

James S. Hagedorn - *The Scotts Miracle-Gro Company - Chairman & CEO*

And how is that businesses doing, by the way?

Thomas Randal Coleman - *The Scotts Miracle-Gro Company - Executive VP & CFO*

That business is doing extremely well.

Operator

And will take over next question from Jon Andersen from William Blair.

Jon Robert Andersen - *William Blair & Company L.L.C., Research Division - Partner*

Boy, I'm almost afraid to ask, given the length of the call. But just quickly, if you can talk a little bit about or compare...

James S. Hagedorn - *The Scotts Miracle-Gro Company - Chairman & CEO*

It's been an hour. It's not that long.

Jon Robert Andersen - *William Blair & Company L.L.C., Research Division - Partner*

It feels longer. It's been a long day. Could you compare and contrast a little bit, though, how your business with -- how you go to market, how you interact, how you do business with large-scale growers versus the hobbyists, who, I'm assuming, principally buys it at one of the hydro retail shops. So if the industry is moving towards large-scale, sophisticated professional growers, how do you, as Scott, how do you leverage Sunlight to do business with them? I mean, these folks aren't showing up, presumably, buying lighting and nutrients at a hydro retail shop. I'm looking for a little bit better sense for your ability to kind of serve that large customer, what capabilities you may need to add to do a better job going forward. And then if you could just comment on your Canadian business? Are you doing business with some of the large LP growers up there? And what's your penetration up there? And how does the federal mandate there change your business -- or impact your business?

James S. Hagedorn - *The Scotts Miracle-Gro Company - Chairman & CEO*

The answer to the latter part is, yes. Jim or somebody can get back to the penetration level, but I think we're pretty happy with that business in Canada. And for sure, the federal legality of that business gives us a lot more room to play and work and be the kind of vendor that we want to be. I don't know if that makes any sense. And that's why we're going to place probably the world's best R&D facility in Canada, and we're in permit right now, just waiting to get through that -- the permitting process, working with another -- with one of the big LPs. So I would say, we're an important participant in the Canadian market and it's well-evolved, if that makes sense. What was the other part of the question?

Thomas Randal Coleman - *The Scotts Miracle-Gro Company - Executive VP & CFO*

(inaudible)



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James S. Hagedorn - *The Scotts Miracle-Gro Company - Chairman & CEO*

I would say -- the only caution I would say is that I want to really take my hat and sort of wave it to our credit partners with the banks. They're coming out of an environment where compliance and enforcement are major deals for them, as is reputational risk. So that us operating through hydroponic retail, I think everybody was relatively comfortable with. The market is clearly moving toward larger gross to support those grows, it's obviously -- it's a professional business. The sales force will be a more professional, technical sale, as you would expect whether it was hydroponics for leafy greens. You'd have a professional salesperson running that business. One of the things that we think we offer with the strength of our entire business is to have a very technical support -- a very heavy technical support presence that is, to some extent, combined but in addition to the sales force, which is that, if you spend a lot of time, and I'm not intending to be dismissive of technique out there, but there's a lot of old wives' tales of how this product's grown. And some people do a fabulous job and other people need help in their greenhouses. I think that if you look at us in [depot], a lot of -- we tend to be one of the best vendors because we have a very deep support system set up from our largest retailers to deal with issues, to get in there. And while it's more of a commercial kind of support system, this is system where I think need to be a very deep technical support system to some sort of help them with a pretty high value product that they're trying to create, and so that will have to happen. We'll have to have a product offering that gives them pretty much what they need. So instead of having 5, 10 vendors, they can deal with everything with a single relationship, a single technical support group that operates -- I'm talking you pick the phone up for Face Time and you need help, you're going to have it instantly. So we need a product line that fully supports the sort of tiers of the business that we think are the most valuable, and we're going to have to do that. The part that I think we're trying to still get through is how to be sensitive to our banking partners because our access to capital is really important. I think this is a business -- and I'm sure I'm making people uncomfortable now. But we moved from a period, call it 5 or 6 years ago, when people said don't even mention that word if you want access to our balance sheet, to I think we've worked really well with our lending partners to get to the point where they're very comfortable or mostly very comfortable with where we are. I do think, as we go where the market is demanding more direct sales, we're just going to have to like work through maybe other people and figure out a way to do that where we don't jeopardize our ability to access the capital markets. And so we can do this, and we have lots of thoughts on how to do that, but that's the part that we're kind of working on right now is to get through that. But I do want to sort of acknowledge that we've made a lot of progress with our -- like our creditors in regard to the business we're in. We've done that openly and cooperatively, and I think we got just through a major facility and I'm super thankful for that and we are sensitive to what makes them sensitive, and we're working through that. But for sure, I think we see a market that's going more direct, and we just need to do that in a way that people are comfortable with. And we can, and we'll find a way to do that.

Operator

And we'll take our next question from Eric Bosshard from Cleveland Research Company.

Eric Bosshard - *Cleveland Research Company - Co-Founder, CEO, Co-Director of Research & Senior Research Analyst*

I'm curious, I hear your optimism, Jim. And relative to 90 days ago, it sounds like California is stabilizing and there's light at the end of the tunnel, and your position for where the market is going. Considering all that, I'm surprised to hear you express less confidence in the \$120 million target you laid out for 2020 when you bought Sunlight 90 days ago. And so what, in 90 days, looks different that you feel like that's no longer a number that you want to stand up to?

Thomas Randal Coleman - *The Scotts Miracle-Gro Company - Executive VP & CFO*

Eric, this is Randy. It's really not a reflection of anything we expect to happen in '19 and '20. It's a reflection of the softness that we've seen in the last 100 days since we announced the deal. So we continue to expect softness across the year, but as the year has marched on, sales have become softer, and it's just a reflection of what that means. So actual growth expectations and the integration and the synergies and everything related to the Sunlight deal, that's not where we see any softness at all. It's just the starting point that we're going to begin with in 2018.



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James S. Hagedorn - *The Scotts Miracle-Gro Company - Chairman & CEO*

Listen Eric, I've always viewed you as a really good analyst and you ask hard questions. So let me kind of tell you like the journey a little bit for me, and it's real time, which is there -- Hawthorne is on their own long-term plan. And they're clearly off their first year, the question is how fatal is that to the performance requirements in the plan. And how do we, as someone who is trying to create incentives for performance, is it queered or is it not? And in those discussions, both internally with my HR group, with our Comp and Org Committee, we're trying to understand what that journey is toward recovery back to the financials that we talked about and that the acquisition was based on. And we're just not there yet. And Randy and I have talked about a lot of this just this week, which is we are -- and so I went back to Hawthorne and said you guys show us like where you're going. And dude those bastards are gun shy as shit, right now, okay? So I'm kind of -- I'm just telling you, realtime, living my life, what do you expect they're going to throw back at us? So they throw these numbers back at us, and it's like, what the hell. And I think just recognize the world they're living in, which is head down day to day, okay? And so that was like last week. Randy was on vacation last week, Randy and I talked when he was up in Maine, and I said, look, if they don't like get their head around these numbers and we're -- what we committed to and where we're going and the business we drive, Randy and I, we'll just tell them what the numbers are. And I know that sounds harsh, but that's kind of what we do here. And we are not behind where we would normally be in our '19 budgeting, and they're really working hard. So I'm going to give them credit for -- they've got like 30 hours a day of stuff to do. We're a little less frantic here. But that said, we're probably a month or 2 to -- from finalizing our budgets, I don't know Randy, if you sort of agree with that number.

Thomas Randal Coleman - *The Scotts Miracle-Gro Company - Executive VP & CFO*

Yes, where we typically are this time of year.

James S. Hagedorn - *The Scotts Miracle-Gro Company - Chairman & CEO*

And so when people have asked me, "What do you think about those numbers that came back from Hawthorne?" I said, "It's a fucking -- sorry for the language, it's a fucking negotiation, and they're gun shy at the moment. And Jim and Randy, I think probably more than like anybody in this room are -- and I acknowledge this, it's just do not overcommit. That's what they would tell me. Do not overcommit. Our credibility matters. I get where our stock price is at. I'm not all freaky on it. My view is what you're telling us is proven, we will. And I'm very confident in that, but I think, in the world of prove it, don't compound it by overpromising. And so I think that's a lot of what's driving sort of the answer to your question, which is when do you get back to that original number. And I just would say bear with us, we're working on it and it's -- this is exactly what management teams do is go through a process of trying to challenge the business, create performance, not ask them to overcommit to something that's unachievable, something that lives up to the commitments we've made to you guys and to our shareholders. And that's the balancing act we're in right now. And I hate to take the time on the question, but that's the real answer, and I think you deserve it.

Eric Bosshard - *Cleveland Research Company - Co-Founder, CEO, Co-Director of Research & Senior Research Analyst*

So just to make sure I understand, like the world hasn't eroded in the last 100 days to make that the wrong number, that was just perhaps too aggressive of a number. I don't mean to give you those 2 choices, but I'm trying to understand which it is, if things have gotten incrementally worse in 90 days or that was an overly aggressive -- there's no reason to hang that number out there to start. That's what I'm trying to understand.

Thomas Randal Coleman - *The Scotts Miracle-Gro Company - Executive VP & CFO*

Well, we've collectively called the total company numbers down at the conference in mid-June. A lot of that was tied to expectations around Hawthorne that did -- said -- were a lot less by mid-June than where we thought we were going to be in mid-April. Beyond that, when you think about the actions we're taking and the plans we have for '19 and into '20, no changes to those plans, those actions, any kind of expectations. It's simply, from mid-April until now, volumes dropped, absorption loss has been worse than we expected. The mix has been off a little bit and the earnings drop-through from that is just creating a new base that's lower than what we would have thought 100 days ago. So it's nothing about what we expect going forward. It's just this year has turned out to be worse than we would have expected.



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James S. Hagedorn - *The Scotts Miracle-Gro Company - Chairman & CEO*

But look, because I think this is maybe the most single important question in regard to this call is where are you all at. And I'll tell you my expectations as the Chief Executive and someone who is -- I work here every day. My expectations, and you can listen, because this is important to the people in Vancouver, my expectation is we get back on that the track. Another question is, how long is that going to take us? And I think that's the real issue. So I'm not saying -- there's no lack of commitment to those numbers. If the question is -- a little bit look at like their long-term incentive. Was, what had happened in this year, the disruption in this year, I think that's the word we've been using, like fatal to their long-term plan? And if so, how do we get them back on their plan and get back on the track that we committed to. And the question is just how long is that going to take and I don't think it's a tremendously long time, but I think there's a lot of work happening to figure out exactly what that means, and it's happening right now. And Mike is not here with us right now. My strategy group is not here with us right now. They're all out in Vancouver not only preparing for a board meeting but dealing with this specific issue.

Operator

And we'll take our final question from David Stratton from Great Lakes Review.

David Michael Stratton - *Great Lakes Review - Research Analyst*

Just briefly, I was wondering if you could highlight, in the ever-changing tariff environment, what you're seeing? I know you called out that it's going to be something tough to absorb in '19. And any color you can give around where you're seeing the tariff impact, if not quantify it, and how you take that into account going forward?

Thomas Randal Coleman - *The Scotts Miracle-Gro Company - Executive VP & CFO*

Sure, David, so in that \$20 million or so estimate we have for next year, there's a few million dollars of tariffs. Some of that is in the U.S., some of that in Hawthorne as well as you'd expect, largely from imports from China. Pricing is being considered for that not only our U.S. business, but we'll likely have to take some pricing on certain SKUs and Hawthorne as well to cover that. This latest news on the newest side of tariffs, that's something that we're evaluating now. Potentially, we may even need to go back to our retailers and ask for more pricing on certain products they will be affected. So time will tell. We're evaluating it. There's other risk mitigations we're considering beyond pricing but we're on top of it and we just want to make sure we're doing the prudent thing as we navigate through this one.

James S. Hagedorn - *The Scotts Miracle-Gro Company - Chairman & CEO*

But I think, largely, metal and plastics out of Asia are the big kahuna there.

Jim King - *The Scotts Miracle-Gro Company - Chief Communications Officer and Senior VP of IR & Corporate Affairs*

All right, Celestina, I think we are done with the Q&A session. A couple of reminders for the folk, if you've follow-up questions that we didn't get to, feel free to call me directly, again, (937) 578-5622. As Jim said earlier, we've got a board meeting on the West Coast this week, so I'm going to be traveling for that as well. So I'll be as creative as I could be with my calendar, but I will get to as many of you as I can over the next 48 hours. Now separately, Randy and I are going to be out on the West Coast in September and, I think, making a run through Texas as well. So hopefully, we'll see some of you in person. Other than that, our next public communication is probably going to be at our year-end conference call at the beginning of November. So we will talk to you then. Thanks for joining us today, you guys. Have a great day.



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Operator

And that concludes today's conference. Thank you for your participation. You may now disconnect.

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